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**MEMORANDUM**

**Date:** 28 September 2000

**From:** Stephen R. Koontz

**Re:** WORC Petition

I am writing to voice opposition to the WORC petition. I would also like to communicate that I support the analysis of the WORC petition by the GIP&SA.

The WORC petition is effectively a prohibition of contracting between cattle feeding enterprises and meatpacking enterprises. The petition asks the Secretary to require that contractual arrangements be opened to bidding. Given that this is not the method in which contracts are formed and that there are no effective means through which bidding can be conducted, the petition is a ban. There is little evidence which suggests that these changes will improve the functioning of fed cattle markets and there is evidence that suggests these changes will harm the marketplace.

(I would in fact like to see the electronic marketplace that the WORC membership insists would emerge if bidding was required. However, I would like to see it emerge and become the dominant form of trading not due to legislation but because it worked better. I would rather see public resources devoted to developing such a market – and then see if it works – as opposed to legislating the current system out of existence and assuming the new system will emerge. My intuition is that there are a number of serious problems with an electronic marketplace for fed cattle and that this system has not been developed because of these problems as opposed to it does not exist because of power.)

The argument for the changes in the petition given by WORC is based on the suggestion that meatpackers exercise market power through the strategic use of captive supplies or contract cattle. This argument is based on a false premise.

I do not dispute the argument that meatpackers exercise market power. Much research demonstrates that this is true. I dispute the magnitude of the impact. I will focus much of my comments on this issue. It was missed by the academic panel at the USDA public forum in Denver.

There was much discussion at the public forum about the negative correlation between captive supply use and fed cattle price. I agree with the statements made by Dr Schroeter, Dr Purcell, and Dr Schroeder. Correlation does not imply causation. We do not know with absolute precision the causal relation between the two. (This is largely a problem with the dominant form of research methodology – falsification – we cannot prove things we can only disprove things.) However, I disagree that we cannot draw a conclusion relevant for policy.

First, let us assume the worst. Let us assume that the entire negative correlation is due to market power. In this case, the losses to the cattle industry caused by captive supplies is approximately \$0.15 to \$0.25 per head. The total loss due to market power is \$1.5 to \$3 million. This statement bears repeating. The total loss to the cattle industry due to the exercise of market power through the use of captive supplies is at most \$1.5 to \$3 million.

Second, I must disagree with Dr Schroeter and Dr Schroeder in that, “We just don’t know.” That is true in the strict form of falsification. But the 1996 P&SA study made a concerted effort to assess whether or not meatpackers use captive supplies strategically to influence price. We built simultaneous equations models of captive supply use and fed cattle price, and we conducted model specification tests to determine the source of the simultaneity in the system. We attempted to answer the question do captive supplies cause price or do prices cause captive supplies. The answer to this question was clear. There was no strategic use of captive supplies. At worst, meatpackers deliver cattle from the least-cost source. All the evidence that increases in captive supply use causes decreases in cash market prices are mirrored by the fact that decreases in captive supply availability causes increases in cash market prices. So prices are lower when captive supplies increase to 75% of the market trade but when the captive supply use decreases two weeks later the price recovers. Further, even then we must remember the magnitude is very small.

The magnitude I report is much smaller than the loss figure developed by Dr Durham for WORC. The losses that WORC was originally stated were \$527 million per year and the number has since increased to \$1 billion per year. These loss figures imply the exercise of market power through the use of captive supplies is approximately \$20 to \$40 per head. There is absolutely no research which supports this per head figure. This statement also bears repeating. There is absolutely no research which supports the magnitude of the losses reported by WORC and attributed to captive supplies. I have reviewed the publically available documents that WORC has provided on Dr Durham’s calculations. The approach is flawed and wrong. The losses she reports cannot be constructed from the Ward, Koontz, and Schroeder portion of the P&SA study that she references. When I do the math, I come up with \$1.5 to \$3 million per year. This is not a hairsplitting academic critique or a matter of interpretation. It is not a matter of judgement. The elasticities she used are not reported in the P&SA study and other portions of the method are just simply wrong. The losses quoted by WORC are 175 to 667 times greater than that which can be supported by published research. (And I want to be forceful in discrediting the WORC figures because it is implied that the magnitude of dollar losses is supported by my research.)

The magnitude numbers that I reference are supported by almost the entire body of literature and research on any source of market power in the meatpacking system. Gains to efficiency are orders of magnitude greater than losses due to the exercise of market power. Dr Harl and Dr Carstensen are incorrect on this issue. Efficiency does matter and the evidence that concentrated industries are concentrated because of efficiency is enormous. A literature review is provided by Dr Azzam and Dr Anderson in the 1996 P&SA study which documents the efficiency gains. Further, Dr Carstensen bases his arguments on studies that were conducted on this issue in the 1970s. This body of research largely has almost no credibility now. It is useful only from the history of economic research perspective. Current research methods are much improved and are not consistent with his claims.

I was most intrigued and discouraged by the comments made by Dr Harl and Mr Stumo. Dr Harl talks about incipency. The idea is that we do not have to wait for market power to be exercised before we do something about it. I agree that this is good. We have to right to institute changes before the bad things happen. However, that is as far as I agree. I would agree with his statement if the behavior is obviously pathological. But it is not. The academic panel made that clear through their statements that said basically that captive supplies are not a problem and their lack of support for the WORC petition. So you could also interpret the emphasis on incipency to say that we don't need any evidence. (The bandit impersonating a policeman in the movie *Treasure of the Sierra Madre* said it more clearly, "Badges? We ain't got no badges. We don't need no badges. I don't have to show you any stinking badges.") Mr Stumo is more direct. His statement basically says the Secretary has the power to rule in favor of the WORC petition and that the ruling need not consider any costs or benefits of the change. There is no need to prove guilt. There is no need to prove the benefits outweigh the costs. The Secretary has the discretionary power. He just needs the will. I hope that I am never on the receiving end of that type of justice.

The comments by Dr Harl and Mr Stumo are of terrible concern to me, in part, because of the potential for unintended consequences. However, that is not all. These comments violate basic principles of science and fairness. This path is a slippery slope. Do we base policy entirely on rhetoric or do we make use of what we know as the truth from science? I hope for science.